ESG – “plus” for sustainability, “plus” for performance?

Hans-Jörg Naumer | 25/09/2018

Summary

This article illustrates the considerable growth in the importance of CSR[1] and ESG for companies and investors. The added value consists not only of a “plus” for sustainability, but may also result in a “plus” for performance, as documented by academic studies.

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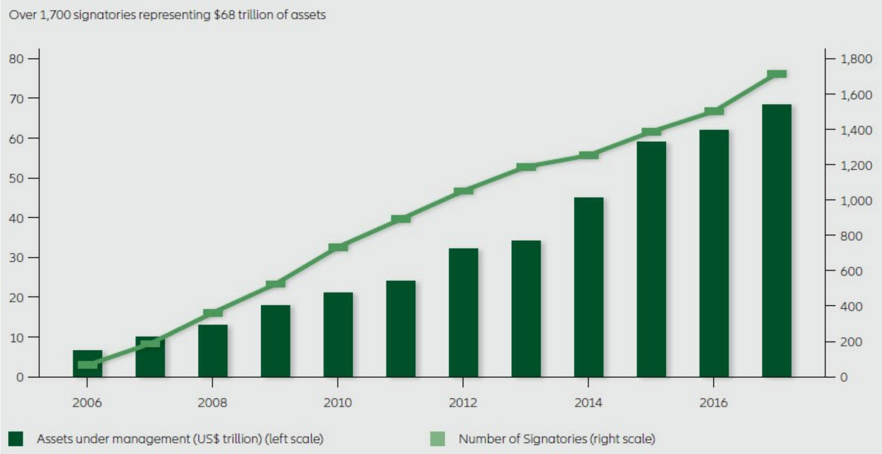
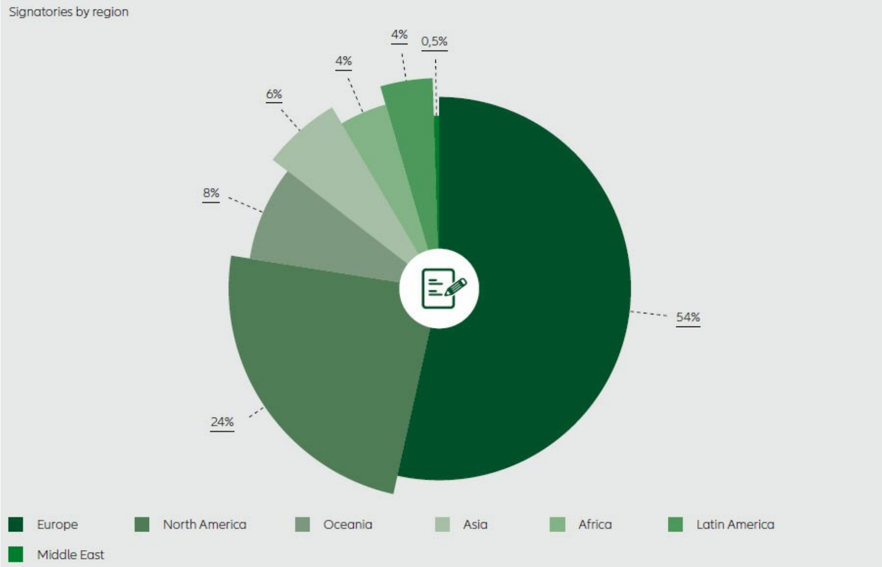
1 Strong gain in importance over recent years

ESG-related investments have long outgrown an investment niche. This is demonstrated not only by the rising volume of capital that is managed on these principles, but also by the intensified research into this form of investment. Capital that is managed according to the United Nations‘ Principles for Responsible Investment (PRI) now amounts to about USD 60 trillion – half of the institutional funds managed globally.

This leads one to ask whether it is ultimately worthwhile investing on a sustainable basis. Ideally, sustainable investing would not be a disadvantage but a “plus“ for the capital investment. (See Figure A/)

A/ The PRI initiative has grown consistently since it began in 2006. The principles for responsible Investment is a voluntary set of six investment principles based on ESG criteria.





Source: unpri.org. Data as of 23 May 2018. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific AllianzGI product. Past performance is not indicative of future results.

2 What impact does ESG have on investments?

But how does ESG affect capital investments? The abundance of studies devoted to CSR/ESG can be roughly divided into those that research CSR's impact from the company's point of view, and those that look into the potential performance impact for investors.

Studies focusing on corporate success analyse the issue of financial performance. To wit, does CSR lead to better corporate financial performance (CFP) and contradict the assumption that this involves only costly measures that could eat into corporate profits? The portfolio-based analyses use the performance of ESG-based investments, hence the direct outcome for the investor.

> "Nowadays the market value of an increasing number of firms can be explained by intangible factors – R&D strength and product innovation, process patents, expertise of their employees, brand power, consumer trust, etc. The Environmental, Social and Governance (ESG) dimensions are an integral part of these value drivers. Companies are attractive to investors if they recognise the ESG factors relevant to their enterprise, invest in them, see them as a business opportunity and manage them well. Conversely, companies that are poorly managed and ignore the ESG factors that are important to their future success are an especially risky investment."

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors

Classification according to the Sustainability Standards Accounting Board (SASB)

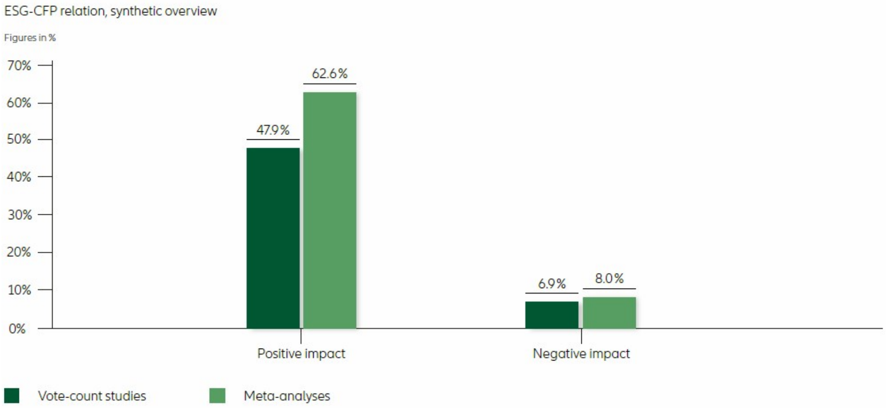
Environment	Social	Governance
GHG emissions	Human rights	Systematic risk management
Air quality	Community relations	Accident & safety management
Energy management	Customer welfare	Business ethics
Fuel management	Data security & customer privacy	Incentive structures
Water and wastewater management	Fair disclosure & labelling	Reporting & audit practices
Biodiversity impact	Labour relations	Competitive behaviour
Lifecycle impacts of products & services	Fair labour practices	Regulatory capture
Environmental, social impacts on assets & operations	Labour standards in the supply chain	Political influence
Product packaging	Employee health, safety & wellbeing	Materials sourcing
	Diversity & inclusion	Supply chain management
	Compensation & benefits	
	Recruitment, development & retention	

Source: www.sasb.org

3 From the company's perspective: CSR and CFP

But how does ESG affect capital investments? The Apparently the widest – and easily the most current – study on the correlation between ESG and companies' financial results was carried out by Friede et al.[2]. This meta-analysis reviewed 2,200 studies from the 1970s to today, including the primary and secondary data of these studies, and found that in the overwhelming number of cases (about 90% of the studies) a non-negative correlation. Around 60% of the studies found a clearly positive relationship between CSR and CFP, i.e. a positive influence on corporate results. Fewer than 10% of all studies found a negative correlation.[3] (see Figure C/)

C/ ESG factors have had a material impact on investment performance



Source: Gunnar Friede, Timo Busch & Alexander Bassen (2015): "ESG and financial performance: aggregated evidence from more than 2,000 empirical studies", Journal of Sustainable Finance & Investment, 5:4, 210–233. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific AllianzGI product. Past performance is not indicative of future results.

Friede et al. made a distinction between so-called "votecount studies", in which the meta-studies they referred to counted only the results of primary studies ("positive", "negative" and "neutral") and meta-analyses that referred to the primary studies' underlying econometric estimates, and aggregated these into an overall analysis. However, both analysis approaches came to the same conclusion, with deviations between individual asset classes.[4] The votecount studies found a significantly higher positive correlation between ESG factors and financial performance in bonds and real estate than in equities, but the analysis was dominated by equities.[5]

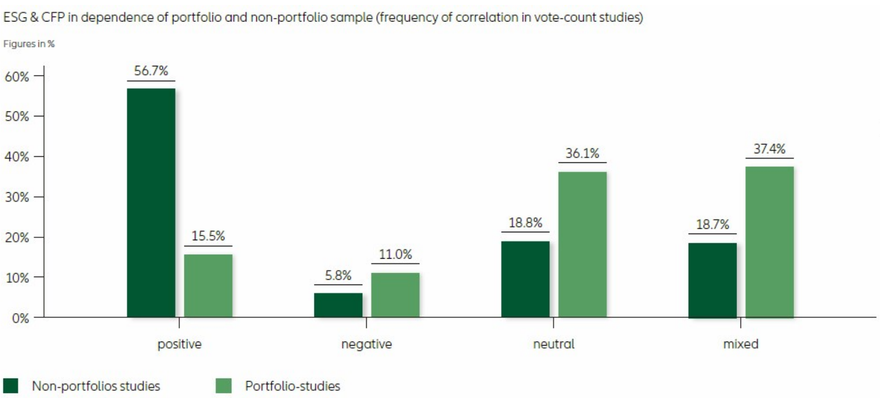
"Incorporating performance-relevant ESG factors into the wider investment universe can help generate better results. Not only equity portfolios, but also corporate and government bond portfolios and alternative investments may benefit."

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors

4 The weaker the legal framework, the higher the importance of ESG

Broken down by country, emerging economies showed by far the most positive correlation between ESG and CSP. This is to be expected, as the protection of investor rights is weaker in emerging economies than industrialised economies, and hence voluntary ESG measures make the biggest contribution to lowering investor risks. This matches the finding by Friede et al. that governance is the most prominent component in ESG. Also noteworthy in this context is the fact that most scientific studies found a positive contribution in emerging economies. [6, 7] (seeFigure D/)

D/ Have ESG portfolios demonstrated significant out- or underperformance?



Source: Gunnar Friede, Timo Busch & Alexander Bassen (2015): "ESG and financial performance: aggregated evidence from more than 2,000 empirical studies", Journal of Sustainable Finance & Investment, 5:4, 210–233. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific AllianzGI product. Past performance is not indicative of future results.

5 From the investor's point of view

From the investor's point of view, the research review by Friede et al. comes to a somewhat less impressive but still positive conclusion. Addressing the issue of whether ESG factors have the potential to also enhance investment returns for investors, they report that only about 10% of studies found a negative correlation between CSR and investment performance. However, the number of studies finding a neutral or mixed outcome is higher than in the studies undertaken from the companies' point of view. The number of studies that conclude unequivocally that there is a positive relationship is lower, at about 16% of portfolio-based studies. It should be noted, however, that the findings are skewed by the fact that the portfolios are allocated on the basis of widely different investment approaches.

All in all, Friede et al. conclude from their comprehensive assessment of ESG-related studies that long-term responsible investing is important for all "rational investors" in meeting their fiduciary duties.

Allocation with reference to ESG criteria when stock-picking shows that doing good and generating returns does not have to be a contradiction. On the contrary.

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors, commented: "For an active asset manager, integration of ESG factors may be critical for success. They must be managed proactively, weighing up the potential risk/ return of the portfolio. A pure ESG overlay, which takes ESG research data from third-party providers and applies it to portfolio strategies indiscriminately via filters or exclusion lists, is not effective. A more correct approach is to form one's own opinion based on proprietary fundamental research, and treat performance-relevant ESG factors, analysed with the proper expertise, as a further investment signal. It is vital to get a clear understanding of a specific investment case if one is to avoid ESG "torpedoes", and exploit ESG investment opportunities. In a low-interest-rate environment, every basis point of investment performance counts!"

This article was first published as part of Update Magazine.

1) Corporate Social Responsibility.

2) Cf. G. Friede, T. Busch, A. Bassen: ESG and financial performance. Aggregated evidence from more than 2,000 empirical studies, in: Journal of Sustainable Finance & Investment, 5. Jg. (2015), H. 4, p. 210–233.

3) On ESG's importance for investments, see also: S. Hörter, ESG in Investment Grade Corporate Bonds, Allianz Global Investors, 2016; and S. Hörter, ESG in Equities, Allianz Global Investors, 2015.

4) Cf. also: G. Friede, T. Busch, A. Bassen: Impact of ESG factors on the performance of firm investments, in: AbsolutImpact, 01/2016.

5) The analysis encompasses 334 studies, including 291 equity, 36 bond, and 7 real-estate studies.

6) Cf. R. Laporta, F Lopez-de-Silanes, A. Schleifer & R. Vishny, Legal Determinants of External Finance, in: The Journal of Finance, Vol. LII,

No.3, July 1997.

7) Cf. K. Gugler, D. C. Mueller, B. B. Yurtoglu: Corporate Governance and Globalisation, in: Oxford Review of Economic Policy, 20. Jg. (2004), H. 1, p. 129–156; cf.: The Impact of Corporate Governance on Investment Returns in Developed and Developing Countries*, in: The Economic Journal, 113. Jg. (2003), H. 491, F511-F539.

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